

LONG-TERM STABILITY OF GENERAL FUND

INTRODUCTION

The state general fund is the primary account that funds a significant portion of the general operations of state government. Since this fund is critical to the operations of state government, the long-term stability of this account is an issue that must be examined for development of sound fiscal policies. This section of the document discusses three key issues relevant to the 2007 legislative session and the necessary planning for subsequent sessions. The issues addressed are: 1) revenue stability; 2) reliance on federal funds; and 3) funding demands.

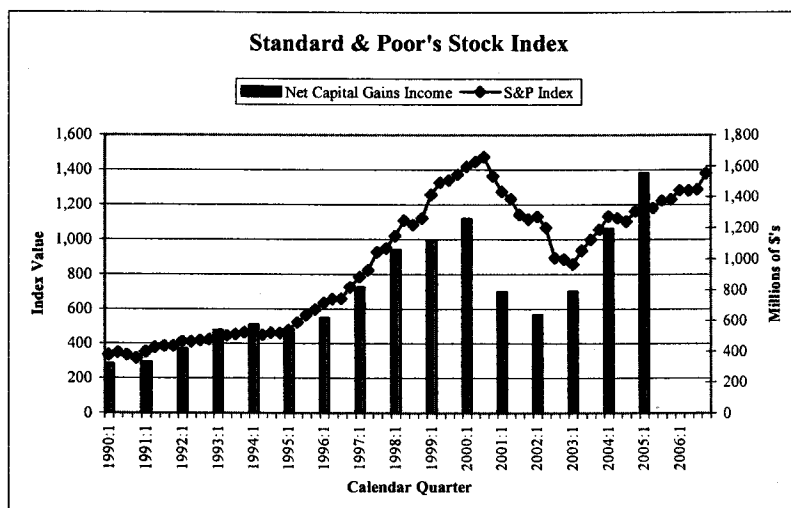
REVENUE STABILITY

There are three major components of general fund revenues that have contributed to increased revenue collections in recent years: capital gains income, oil and gas price and production, and corporate profitability. Reliance on capital gains upswings is the "poster child" of over-reliance on sustained growth, and expanding government services based on unsound fiscal policy.

Capital Gains

The 1990's were generally good years for Montana's economy. With a few exceptions, Montana experienced above average employment and wage levels that translated into strong tax revenue growth. This revenue growth was further enhanced by the significant increase in the equity markets and the resulting growth in capital gains income. During calendar 2002 and 2003, however, the state's financial picture blurred as the effects of a national economic recession, terrorism threats, and mid-east tensions played havoc on the US economy. Although Montana's economic base remained relatively stable during this period, state general fund revenues plummeted. This inconsistency was due to the precipitous fall in equity markets, low interest rates, and reduced corporate profits. All of these factors contributed to the 2002/2003 budget crisis while the state's economy continued to outperform the national economy.

Figure 4



As Montana moves forward into the next century, there are valuable lessons that can be extracted from the financial experiences of the 1990's. For example, as the information technology age was exploding during the nineties, the equity markets were experiencing phenomenal growth rates. As shown in Figure 4, the S&P stock index reached a high of almost 1,500 in calendar 2000 and then declined abruptly until 2003 when the index dropped to about 850. Figure 4 also shows the corresponding trend in net capital

gains realizations as reported on Montana's tax returns. As the figure shows, the trends in reported net

capital gains income is highly correlated to the S&P index. This would indicate that state tax revenues experienced significant growth from the mid to late nineties due to the information technology investment euphoria. In the meantime, while this growth scenario was occurring, state general fund expenditures were increased along with passage of significant tax relief measures. The actions of the legislature, in essence, expanded the expenditure base and reduced the tax base based on the assumption that strong revenue growth would continue indefinitely. Obviously, the budget crisis of 2002/2003 refuted this supposition. For the 2007 and 2009 biennia, an ominously similar pattern may be developing, clearly shown in Figure 4. Reliance on continued levels of capital gains income could lead to another fiscal crisis. A careful assessment of the long-term stability of these levels of income is warranted.

Oil and Gas Production

Again for the 2007 and 2009 biennia, a similar situation may be developing in the oil and gas production component of state revenues. Montana's oil and natural gas revenues are increasing significantly when compared to previous biennia. The issue is whether these increased revenues are "on-going" or are a short-term "blip" (similar to net capital gains income) that may fade in the future.

Figure 6

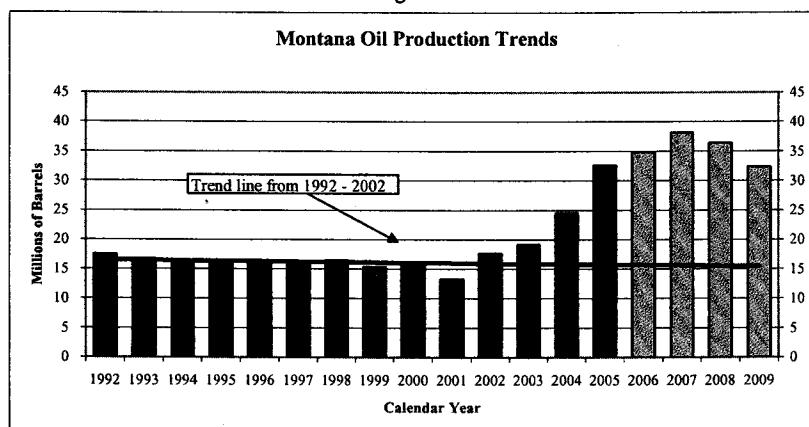
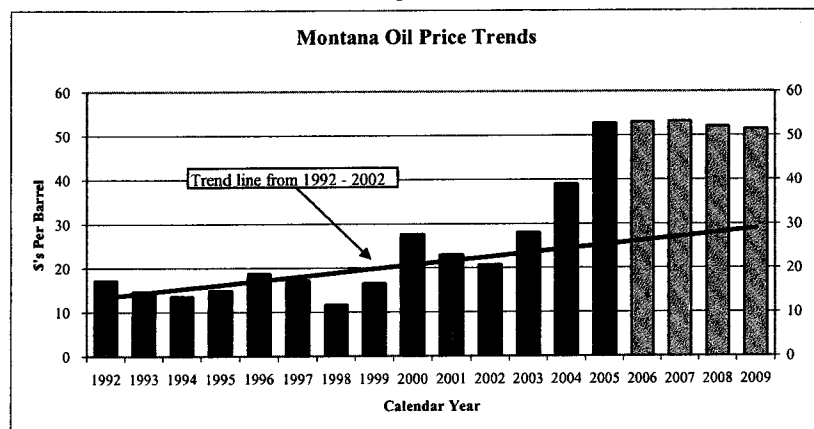


Figure 5



Figures 5, 6, 7 and 8 show the trends in Montana's price and production for oil and natural gas. The data shown for calendar 1992 through 2005 are actual information extracted from the Department of Revenue's computer system. The estimates shown for the period calendar 2006 through 2009 are based on assumptions adopted by the Revenue and Transportation Committee (RTIC) on November 15, 2006.

In addition to the actual and estimated amounts, the figures also show a trend line based on the calendar years indicated in the annotations. These trends are based on a common statistical technique that minimizes the differences between the trend estimate and the actual amount. The trend lines are extrapolated into the future to indicate what the "trend" would be under a status quo situation.

However, both oil and natural gas prices have increased dramatically in response to the war in Iraq and the uncertainty about future supplies.

The RTIC was aware of these conditions and adopted price and production assumptions accordingly. As shown in the figures, it is quite apparent that the price assumptions adopted by RTIC are expected to peak and then begin to trail off by the end of calendar 2009.

It is estimated that the additional revenue due to price and production being above the trend lines could be as much as \$70 million general fund or \$155 million all funds for calendar 2008 and 2009. These estimates most likely represent a maximum estimate since the probability of price and

Figure 7

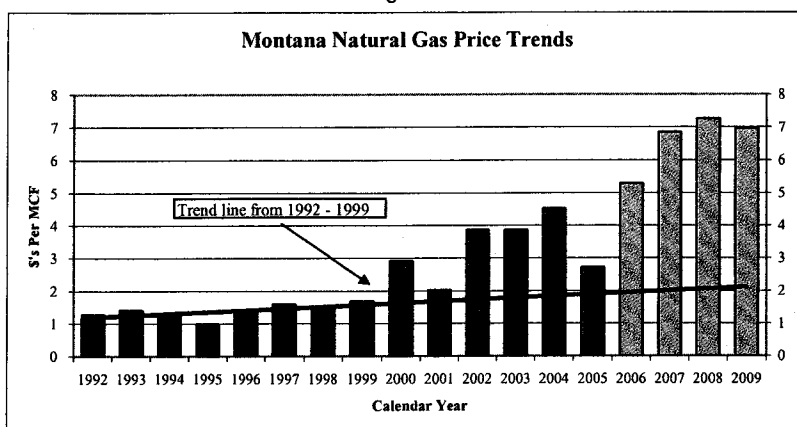
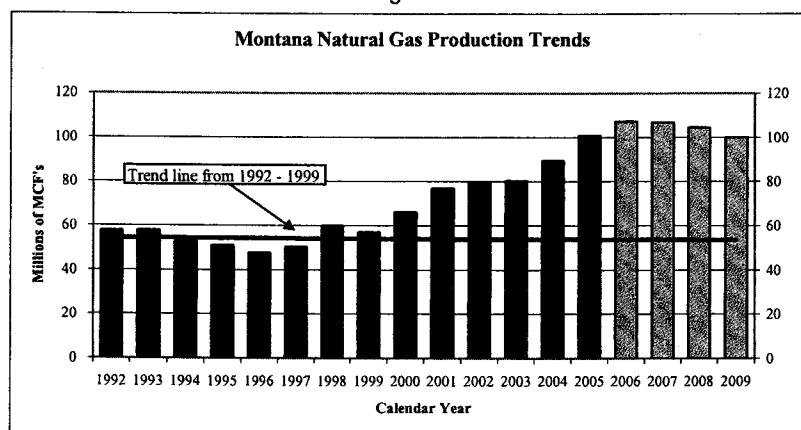


Figure 8



production amounts returning to the trend line amounts are low. Regardless, the legislature should be visionary in the budgeting process and not assume oil and gas revenues will continue at these high levels unabated into the future.

Corporate Income

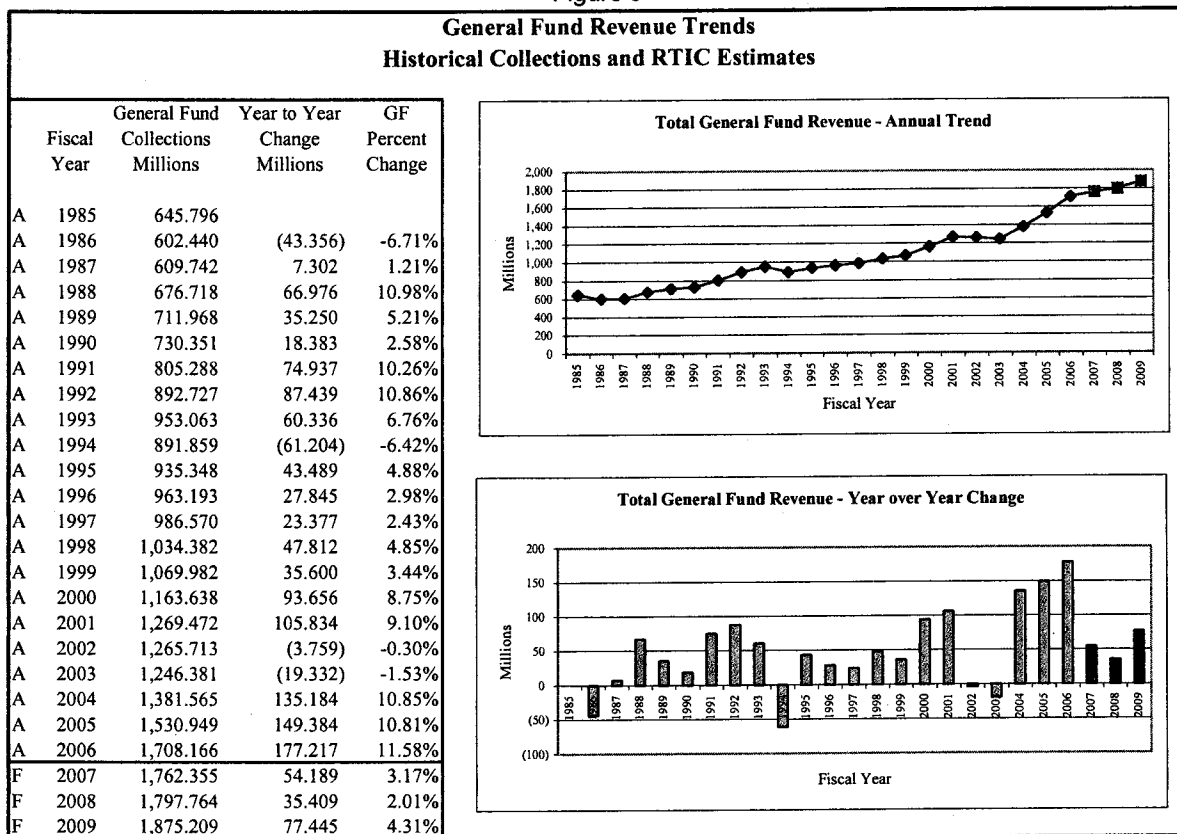
Corporate income taxes have traditionally been an extremely volatile source of revenue,

directly tied to the national and world economic conditions and its erratic fluctuation. While corporate taxes are currently strong, it is again prudent to assess the long-term viability of reliance on sustaining this level of income into the future. A significant portion of corporate income taxes is being "fueled" by the natural resource industry. However, commodity prices could wreak havoc on corporate profitability. This is just one more example of a revenue source that may not be sustainable in future biennia. This issue is discussed in more detail in this volume and in Volume 2, "Revenue Estimates."

Revenue Stability-Summary

As shown in Figure 9, total general fund revenues have increased substantially during the period fiscal 2004 through 2006 and are projected to increase only moderately during FY 2007, 2008, and 2009. The projected dollar increases are consistent with the trends observed from FY 1995 through FY 1999.

Figure 9



From a percentage growth perspective, however, the projected increases are generally a lower percent than in that previous period. Figure 9 also shows the change in revenue collections from year to year. The disturbing trend is the downturn in revenue collections observed at eight year intervals. If this pattern continues, the 2009 Legislature could be facing a difficult budget session.

The downturn in revenues during FY 2002/2003 illustrates the sensitivity of Montana's revenue stream to world events and investment opportunities. It also underscores the potential inaccuracies in the revenue estimates if the occurrences of these types of events are not known or are mistimed. Economic upturns or downturns are rarely accurately projected nor can disasters or certain world developments be anticipated. To quantify current collection patterns, the increased revenue collection of \$462 million from fiscal 2004 to 2006 was primarily due to three general fund revenue sources: individual income, corporation income, and oil and gas production taxes. Together, these three sources of revenue contributed about \$406 million of the total increase, which represents almost 88 percent of the total. The various assumptions used to estimate these revenue sources will have a substantial impact on total estimated general fund revenues in the future. If only a few of the key assumptions miss the mark, estimates may vary widely from actual collections.

RELIANCE ON FEDERAL FUNDS

General fund expenditures have increased on average over 5.2 percent per year from fiscal 1990 to 2006. Correspondingly, federal funds expended have increased over 8.2 percent per year during this same period. In both funds, however, there have been some budgetary changes that skew these percentages. For example, HB124 (local government entitlement legislation), diverted some local government revenues to the state treasury in return for a state general fund entitlement appropriation to local governments. This change increased general fund revenues by approximately the same amount of increased general fund expenditures. During the 2003 biennium, the state food stamp program was included in the budgeting process. Prior to this time, this program was considered "off budget" and was not included as a federal fund expenditure.

Regardless of these changes, the fact remains that federal funds continue to be a much larger portion of the total state budget. As shown in Figure 10, general fund expenditures represented over 60 percent of the combined general and federal fund expenditures in FY 1990. By FY 1999, the percentage split was about equal. By FY 2004, however, federal funds represented over 55 percent of the combined spending to about 44 percent from the general fund. Interestingly, the federal funds percentage has returned to about 50 percent in FY 2006. Total federal funds expended in FY 2006 were \$1.572 billion compared to \$1.567 billion general fund, for a difference of \$4.9 million. If Montana was to lose a portion of these federal funds, the impact on the services provided to the citizens would be significantly reduced. To maintain the same level of services would require a substantial change in state tax policy.

Figure 10

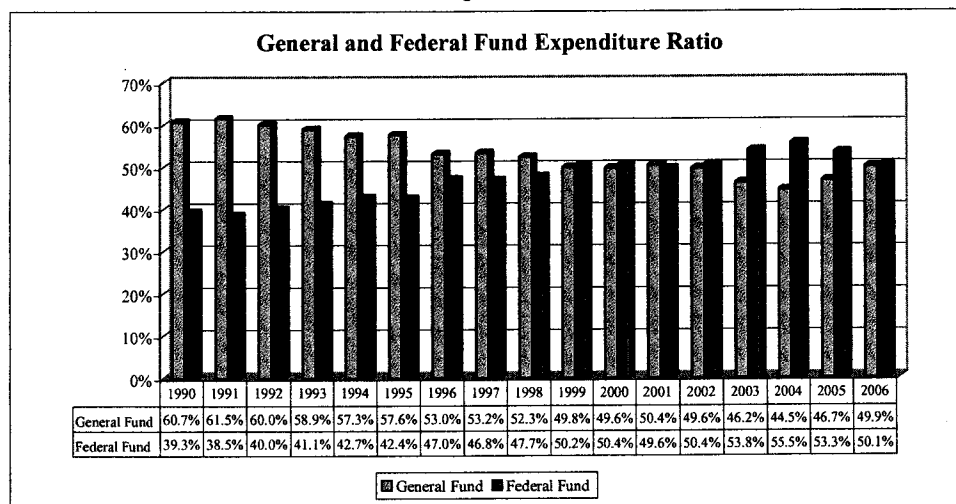
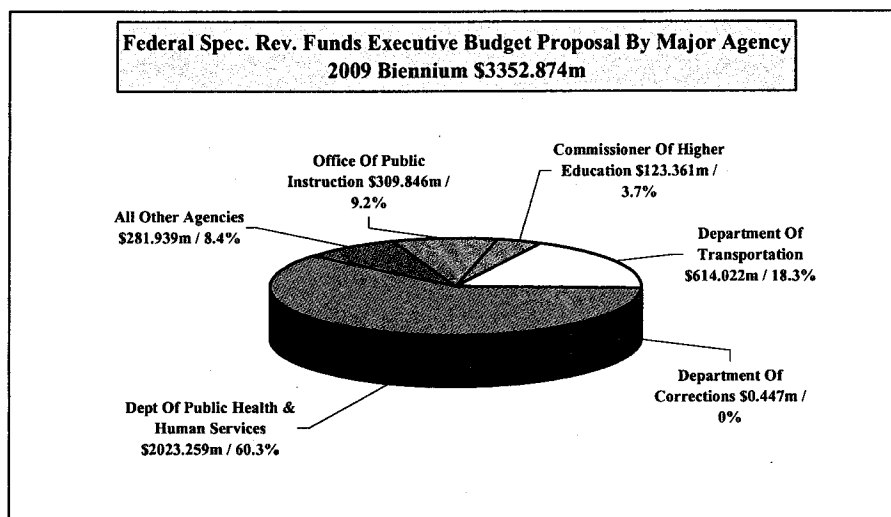


Figure 11 shows the 2009 biennium executive budget recommendation for federal special revenue funds. As the figure shows, public health and transportation services consume over 78 percent of the federal funds recommended in the executive budget. A reduction in federal funding would have a significant impact to these state programs.

Figure 11



Reliance on Federal Funds-Summary

With federal deficits and the continued Iraq war funding demands, the prospect for federal funding freezes or reductions is a real possibility, not only in the near-term but also in the long-term. The recent actions of the Bush administration to deal with large federal deficits, including passage of the deficit Reduction Act, signal a likelihood of federal cutbacks that may impact states. In this biennium, federal cut-backs in human services are felt, and are noted in this budget analysis. The 60th Legislature may want to consider developing a long-range plan in the event of a reduction in federal funds.

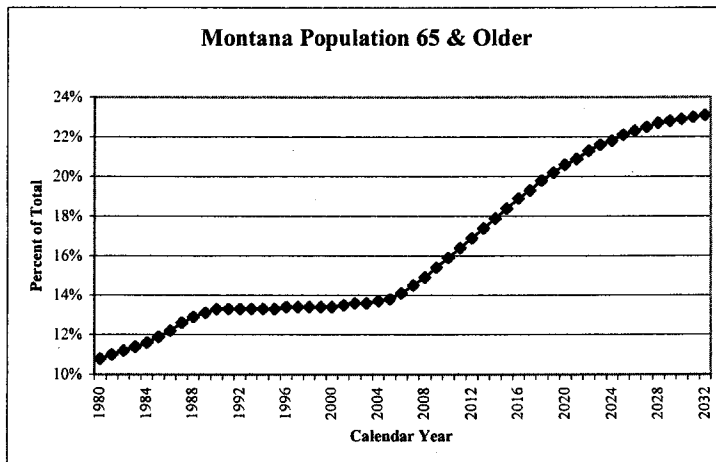
FUNDING DEMANDS

Businesses as well as government constantly experience the changing and competing demands for available dollars. Whether a business is contemplating expansion or technology enhancements, state government experiences the same type of needs and priorities in order to continue services to the citizenry of the state.

Aging Population

One of the most significant events that is beginning to surface in Montana is the projected increase in the aging population. Between 2002 and 2025, Montana's population 65 and older is expected to increase from 13.6 percent of the total population to 22.1 percent, or a change in older residents of almost 100,000. As shown in Figure 12, Montana experienced rapid growth in this age cohort from calendar 1980 to 1990.

Figure 12



Starting in calendar 1991 through 2002, this trend waned with the percentage of residents in this age bracket remaining quite constant. From calendar 2002 to 2024 this trend is once again changing, showing a significant percentage of Montana's total population in the 65 and older age range. If these projections are correct, by calendar 2025 one out of every five Montanan's will be at least 65 years old.

The primary cause of this rising population change is the maturing of the baby-boomer generation, born

between 1946 and 1965. Montana, like other state and local governments, will need to address the issues relative to changing demographics. As Montana's population ages, issues relative to an economy that will be required to support these changes and the implications for medical and long-term care costs must be addressed.

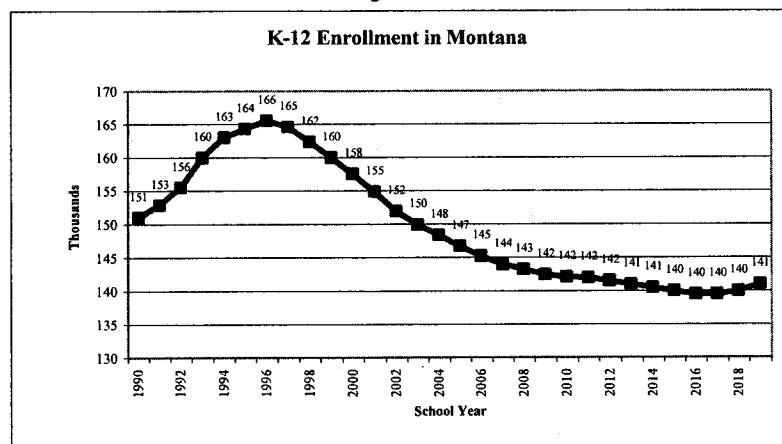
With a growing elderly population, the legislature will need to address how the working-age population can support a significantly older population. In addition to the associated costs of caring for the elderly, the level of income these individuals have and ultimately how much they will pay in taxes could have a substantial impact on state government finances. Given the expected dramatic changes in the age structure of our population, it is imperative the legislature begin thinking about these issues and how they may be addressed in the future.

School Enrollment

In addition to our aging population, Montana has experienced a significant change in enrollment in our elementary and secondary public schools. As shown in Figure 13, Montana's total enrollment was in excess of 165,000 children in school year 1996. From this time forward, total enrollment is expected to decline to about 140,000 students by school year 2015. Beyond 2015, enrollment is estimated to increase, but at a fairly moderate rate. The significance of this change is the

costs associated with funding our current public school system. Under current law, state expenditures for public schools are primarily driven by the enrollment in each district. If enrollment declines, then the

Figure 13



cost to fund education correspondingly declines. See page 175 for a discussion on the current public school funding lawsuit.

If the current public school funding formula continues to be enrollment driven, the cost of funding the public school system will begin to accelerate when the current enrollment trends reverse direction beginning in school year 2015. At an average cost of about \$4,075 per enrollee per year, small changes in enrollment can turn into significant funding increases in the future.

Funding Demands-Summary

Changes in population demographics related to an aging population and a reversal of the decline in school enrollments are just two examples of funding demands. The chronic demands for increased human services and corrections funding are well known, and there are other troubling signs that funding demands could exacerbate the long-term stability of the general fund.

CONCLUSIONS

Ensuring that the general fund is structurally balanced, i.e., that on-going revenues meet or exceed on-going expenditures for the next biennium, provides a simplistic short-term assessment of sustainability of the general fund. However, it does not take into consideration the long-term stability of the funds or whether long-term trend assumptions are based on sound fiscal policies. This section discussed three key issues related to long-term stability that may point to tougher times ahead. With regard to revenue stability, individual income taxes, oil and gas production taxes, and corporate income taxes account for 88 percent of revenue growth in the past three completed fiscal years. Further reliance on sustaining these revenues at current levels into the future would ignore ominous signs that warrant careful scrutiny. With regard to federal funds, the executive budget proposes replacement of \$12.3 million federal funds with general fund due to federal cutbacks, and this appears to be the tip of the cutbacks anticipated as the Federal government deals with huge deficits. Regarding funding demands, shifting demographics related to aging population and school enrollment, as well as challenging chronic growth patterns with corrections and human services, signal yet another reason for concern with long range stability of the general fund. Collectively, these sample issues bring into question the sustainability of an executive budget proposal that, while "structurally balanced" from a simplistic short-term perspective, may lead to budget shortfalls in the not-too-distant future.

LFD ISSUE

While revenue estimates and spending proposals in the executive budget may be based on the best information available, particularly with regard to future sustainability, if only a few key assumptions miss the mark, it could lead to budget shortfalls in the long-term. The legislature should carefully consider the issues surrounding the sustainability of the level of expansion proposed in this budget, and determine the level of risk that is acceptable in consideration of the vulnerability of any economic forecasting assumptions. For the longer-term, an in-depth analysis of the long-term stability of the general fund would require a fairly extensive analysis, but may be prudent given the serious impacts of over-extending based on erroneous assumptions.

The legislature may wish to recommend an interim study of the long-term stability of the general fund. Much could be learned from examining the fiscal policies on which the current general fund structure is based.

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Based on this outlook, it could be argued that a significant amount of additional revenue in the next several years that is currently classified as "on-going" could be considered "one-time" and may not be available in subsequent biennia. If this hypothesis is correct, the 60th Legislature should consider creating a "rainy day fund" and transferring a portion of the potential one-time revenue into this fund. On November 28, 2006, the Legislative Finance Committee approved draft legislation that would create a "budget stabilization account", a term synonymous with "rainy day fund". Given the tenuous nature of some assumptions regarding the long-term sustainability of general fund, a rain-day fund would provide a cushion to get through the down-side of economic cycles.